RBC Wealth Management Services

THE NAVIGATOR

COMPLIMENTS OF
C. D'EON WEALTH MANAGEMENT
GROUP OF RBC DOMINION
SECURITIES

CORY D'EON, BBA, MBA
Vice President & Investment Advisor
(902) 749-4444
cory.deon@rbc.com

KRISTA LEBLANC, B COMM., PFP
Associate Advisor
(902) 749-4443
krista.leblanc@rbc.com

SARAH WIER
Associate
(902) 424-1023

296 Main Street
Yarmouth, NS
B5A 1E4

www.corydeon.com

RETIREMENT AND ESTATE SOLUTIONS USING EXCESS FUNDS IN A CORPORATION

Surplus cash in a corporation – Part 4

As the owner-manager of your operating company, you may have surplus profits accumulating in your corporation. This surplus cash could be in your operating company or it could be in your holding company. In either case it is still a corporate structure and the tax implications are the same.

Your first reaction may be to figure out how to withdraw the funds from the corporation and pay as little income tax as possible. While this might seem like the best solution, other options might be more appropriate depending on your situation and your personal and business needs.

There are many issues to consider when deciding what to do with your corporation's surplus funds. What do you need the money for most? What options are available? And what are the tax implications of those options?

This article, the last in the series on surplus cash, discusses some retirement and estate planning solutions you may consider if you don't have an immediate personal or business need for your corporation's surplus cash.

This four-part series takes you through some of the key issues to consider when you have surplus cash in your corporation:

Part 1: Decision tree for addressing surplus cash in a corporation

Part 2: Taxation of investment income in a corporation

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Even if you have decided that the excess funds in your corporation are not required for business or personal purposes in the short to medium term, you still need to decide whether to retain the excess funds in your corporation or withdraw them.

Part 3: Taxation of business income and methods of withdrawing cash from a corporation

Part 4: Retirement and estate solutions using excess funds in a corporation

The terms 'corporation' and 'company' are used interchangeably to refer to a Canadian-controlled private corporation (CCPC). This means that the corporation is not controlled by a non-resident of Canada or a public corporation and no class of shares of the corporation is listed on a prescribed stock exchange. This four part series does not apply to public corporations or to businesses operating as a partnership or a sole proprietor.

The content is for information purposes only and does not provide tax or legal advice. It is imperative that you obtain professional advice from a qualified tax or legal advisor before you act on any of the information provided in this article. This will ensure that your own circumstances have been properly considered and that action is taken on the latest information available.

When There's No Personal or Business Need for the Cash

Even if you have decided that the excess funds in your corporation are not required for business or personal purposes in the short to medium term, you still need to decide whether to retain the excess funds in your corporation or withdraw them.

The best course of action may be to get the funds out of the corporation in a tax-efficient manner because, in general, in most provinces investment income is taxed very slightly higher in a corporation than personally, even at the highest personal tax rates and having the funds inside your operating corporation can expose these assets to creditors. However, if the funds can be invested tax-efficiently inside your corporation or a holding corporation to achieve some asset protection, it may be better to invest them corporately especially where the funds are not needed in the near future.

As with any planning, when you're deciding whether to keep the funds in your corporation or take them out, a good place to start is by understanding and defining your goals and objectives.

What Are You Going to Use the Funds For?

At this point, you have already determined that there is no short or medium term use for these funds, so you need to think longer term. There are two likely conclusions: you are going to use the funds yourself for retirement or you want the funds to enhance the value of your estate or a combination of the two.

Retirement

You should have an idea of how much money you need for retirement before you proceed with this analysis. The solution for a retirement goal may be different from the solution for an estate goal, and you do not want to be in the position of implementing an estate solution that is not reversible if you need to use these assets to fund your retirement.

Some possible strategies for a retirement goal include:

Dividends: Accumulate excess assets in your corporation and pay dividends in retirement when you may be taxed personally at a lower rate.

Salary: Pay yourself sufficient salaries and/or bonuses during your working years to allow you to maximize your RRSP contributions or to establish and IPP using past service credit.

If you decide to use the surplus funds in your corporation to increase the value of your estate, there are a couple of interesting strategies you can use involving insurance, which offers tax-sheltered growth and a tax-free death benefit.

Corporate insured retirement plan: Your corporation applies for a permanent insurance policy that allows your corporation to invest deposits in excess of the costs of the life insurance. These invested funds grow on a tax-sheltered basis. When funds are required for retirement, the cash surrender value of the policy may be used by your corporation as collateral for tax-free loans. The funds borrowed are then used to provide retirement income. Upon death, the non-taxable death benefit is paid to your corporation, which creates a Capital Dividend Account (CDA) credit in the amount of the insurance proceeds in excess of the policy's adjusted cost basis. Insurance proceeds may then be used to repay the loan. Your corporation then uses the proceeds from the life insurance (and any other capital) less the funds used to repay the loan to pay a dividend to your estate, the majority of which would be a tax-free dividend as a result of the CDA credit.

Retirement compensation arrangement (RCA): Your corporation may deposit funds into an RCA. Your corporation gets to deduct the amount contributed to the RCA when calculating its taxable income. Of the total contribution made to an RCA, 50% is deposited with the custodian of the RCA Trust to be invested, and the other 50% is deposited with the Canada Revenue Agency (CRA) as a refundable tax. In addition, 50% of all dividends, realized capital gains, and interest income earned less expenses in the RCA, must be remitted to the refundable tax account on an annual basis. In retirement, you withdraw the funds from the RCA, hopefully when you are in a lower tax bracket. When benefits are paid to you from the RCA, $1 of refundable tax is recovered from CRA for every $2 paid out of the RCA.

Individual pension plan (IPP): Your corporation may contribute to an IPP for your benefit. Your corporation can deduct the contributions, and the funds in the IPP grow tax-sheltered until you withdraw them in retirement. The funds you receive in retirement from the IPP are taxable at that time at your marginal tax rate.

Estate

If you decide to use the surplus funds in your corporation to increase the value of your estate, there are a couple of interesting strategies you can use involving insurance, which offers tax-sheltered growth and a tax-free death benefit:

Corporate wealth transfer: Corporation applies for a permanent insurance policy that allows your corporation to invest deposits in excess of the costs of the life insurance. These invested funds grow on a tax-sheltered basis. Upon death, the non-taxable death benefit is paid to your corporation, which creates a CDA credit in the amount of the insurance proceeds received in excess of the policy's adjusted cost basis. Your corporation then uses the proceeds from the life insurance to pay a dividend to your estate, the majority of which would be a tax-free dividend as a result of the CDA credit.

Corporate insured annuity ("back to back"): A portion of your corporation's fixed income investments would be used to purchase a non-prescribed annuity and a life insurance policy (to replace the capital used). The annuity would generate an income stream that would cover the cost of the life insurance premium and the tax on the annuity, as well as generate income which could be used to supplement your cash flow. When you pass away, your company would receive the tax-free death benefit from the life insurance policy. The excess of the death benefit over the adjusted cost basis of the policy is credited to your corporation's CDA. Your corporation then uses the proceeds from the life insurance to pay a dividend to your estate, the majority of which would be a tax-free dividend.

These insurance-based estate strategies can also be implemented personally, but this is generally not as effective when the excess funds are inside your corporation especially since the insurance proceeds can generally be paid out of the corporation tax-free through the CDA. It will cost you to withdraw the funds from your corporation to implement the strategy personally.

These strategies can be complex and we have only highlighted them here. We suggest you consult your legal and tax advisor before you proceed.

Qualifying Small Business Corporation

Maintaining investments or an insurance policy in your corporation can affect your company's status as a qualifying small business corporation (QSBC) and your succession plans.

For example, these assets may disqualify the shares of your corporation as QSBC shares so that the $750,000 capital gains exemption may not be available to you on the actual or deemed disposition of your shares. In addition, a potential purchaser may not want to deal with the implications of the corporation owning an insurance policy on the previous owner's life. There may also be tax consequences to changing the ownership of the insurance policy.

Consequently, it may make sense to establish a holding company to maintain the insurance policy as opposed to maintaining it in the operating company. Because this type of structure can complicate your business succession plan, it is extremely important you get professional tax advice when implementing this type of structure.

Asset Protection

Accumulating excess cash in your operating company means that the funds are exposed to claims from your corporate creditors.

One approach to mitigate this issue is to transfer the excess cash into a holding company. There are various ways to do this. However, as mentioned before, this type of planning can be quite complex and it is advisable that you consult with a qualified tax advisor that is experienced in this area.

Any asset protection strategy that you put in place may be undermined if you have provided personal guarantees. In addition, as a director of your corporation, you may be personally obligated for certain liabilities of your corporation.

It is essential that you consult a legal professional regarding asset protection options available to you.

Conclusion

There are many opportunities and solutions available to assist you in meeting your retirement and estate planning goals. However, because of the complexity of integrating your corporate and personal goals, considering the different tax systems, it is essential that you involve the appropriate professionals in order to maximize these opportunities and accomplish your goals in the most tax-effective manner.

Please contact us for more information.

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